

VZCZCXRO6812
RR RUEHCHI RUEHCN RUEHDT RUEHHM
DE RUEHJA #0227/01 0410225
ZNR UUUUU ZZH
R 100225Z FEB 09
FM AMEMBASSY JAKARTA
TO RUEHC/SECSTATE WASHDC 1429
RUEATRS/DEPT OF TREASURY WASHINGTON DC
INFO RUEHJS/ASSOCIATION OF SOUTHEAST ASIAN NATIONS COLL
RUEHKO/AMEMBASSY TOKYO 3008
RUEHBJ/AMEMBASSY BEIJING 5893
RUEHBY/AMEMBASSY CANBERRA 3582
RUEHUL/AMEMBASSY SEOUL 5368
RUEHGP/AMEMBASSY SINGAPORE 6446
RUEAIIA/CIA WASHDC

UNCLAS SECTION 01 OF 03 JAKARTA 000227

SIPDIS
SENSITIVE

DEPT FOR EAP/MTS, EAP/EP AND EEB/IFD/OMA
TREASURY FOR IA/ TRINA RAND AND LOIS QUINN
DEPT PASS FEDERAL RESERVE SAN FRANCISCO FOR CURRAN
DEPARTMENT PASS EXIM BANK
SINGAPORE FOR SBAKER
DEPT PASS USTR WEISEL, EHLERS

E.O. 12598: N/A

TAGS: [EFIN](#) [EINV](#) [ECON](#) [EAGR](#) [ID](#)

SUBJECT: PRESSURE ON BANKS WEIGHS ON INVESTMENT,
GROWTH

1. (SBU) Summary. Emerging pressures on the Indonesian banking sector will suppress credit growth in 2009. While the risk of a liquidity crisis has abated, deteriorating credit quality and high funding costs will squeeze bank earnings and erode capital at weaker institutions. With bank lending set to slow and few alternative sources of financing, the outlook for investment and growth in 2009 has diminished. While the banking sector as a whole remains well capitalized, weaknesses among smaller institutions could undermine investor confidence, increasing the importance of a sound regulatory response to emerging problems. End Summary.

Corporate and Consumer Sectors Under Pressure

2. (SBU) Credit quality in the Indonesian banking sector is set to deteriorate in 2009, limiting the banking sector's ability and willingness to increase lending. Signs of weakness in the corporate sector have already emerged, with some export manufacturers, newer commodity firms and real estate developers struggling to make loan payments, according to analysts. Tighter global credit will also make it difficult for Indonesian firms to repay or rollover the \$10-15 billion in foreign currency corporate loans that will mature in the next twelve months. Some Indonesian banks are also facing defaults on their foreign exchange derivative products. Bank Danamon recently recorded an \$80 million loss associated with customer defaults on derivative contracts. Consumer credit portfolios have also deteriorated, particularly outside Java, where job losses in the commodity-based sectors have increased. Consumer loan defaults doubled in Sumatra in December, rising to 10%, according to UBS.

3. (SBU) Stress tests indicate that large banks can withstand a significant decline in loan quality, but some small and medium-size banking institutions may suffer capital impairment. According to UBS's Joshua Tanja, Indonesia's five largest banks could withstand a 10-12 percentage point increase in non-

performing loans (NPLs) without reducing their capital levels below the 8% regulatory minimum. However, a number of small and medium-sized banks may need capital injections if non-performing loans increase by more than 4-5 percentage points. While the weakest banks do not pose systemic risk on their own, collectively they hold roughly 10% of total banking deposits in Indonesia, according to Tanja. Most bank analysts expect NPLs in the banking system to double in 2009, from 3.5% to over 7%. Bank Indonesia (BI) expects NPLs to rise to 5% this year. Weaknesses among smaller banks may also prompt consolidation in the sector, improving the longer-term health of the banking system.

Funding Costs to Remain High

14. (SBU) Liquidity conditions have eased for the larger banks, but the cost of funds remains high, limiting the banks appetite for credit growth in 2009. Bank analysts note that distrust among Indonesia banks persists, restricting the volume of interbank lending and access to interbank funds for most smaller banks. Growth in banking sector deposits has improved, rising to 15% (yoy) in November 2008 from 11% earlier in 2008, but deposit growth is concentrated in larger banks and lags demand for loans. Credit growth in November 2008 exceeded 35% (yoy), indicating that loan demand remains high. Deposit rates across the sector also continue to climb. Banks offered rates as high as

JAKARTA 00000227 002 OF 003

16% in January, despite BI's 50 basis point interest rate cut earlier in the month.

Less Credit to Take Toll on Economy

15. (SBU) With bank lending set to slow and few alternative sources of financing, the outlook for economic growth in 2009 has diminished. BI officials have called on the banking sector to increase lending by 20% (yoy) in 2009, but bankers view this target as unrealistic in light of rising credit and funding costs. Bank analysts expect credit growth to fall to 5-10% (yoy) in 2009, as bankers tighten underwriting standards and write-down problem loans. While slower loan growth is positive from a prudential perspective, the forecasted rate cannot fuel significant new investment. The lack of access to global financial markets will amplify the impact of slower domestic credit growth, as roughly half the financing for Indonesian corporations has come from external markets in recent years. Plans to issue new government debt could also crowd out private sector financing, as banks opt for relatively safe government bond purchases over corporate and consumer lending.

16. (SBU) Analysts continue to downgrade their growth forecasts for Indonesia as plummeting exports and softening domestic demand parallel the negative outlook for credit growth. Exports fell by over 20% (yoy) in December, as both intra- and extra-regional trade shrank. Observers expect a sharper dip in the coming months. Signs of a slowdown in domestic demand include falling non-oil imports, decelerating motorcycle sales, lower core inflation, and rising job losses. The Economist Intelligence Unit (EIU) expects the formal unemployment rate to jump from 8.5% to 9.7% in 2009. Anecdotal information also suggests day laborers, particularly in the construction industry, are having difficulty securing work. While the government's planned fiscal stimulus should ease some pressure on income

and jobs, the government has limited capacity to mobilize large-scale spending in the near term. Both the IMF and the EIU recently reduced their growth forecast for 2009, to 3.5% and 1.9%, respectively. Some market analysts are more pessimistic, with growth forecasts closer to 1% in 2009.

Bank Weaknesses Pose Risk to Confidence

17. (SBU) While a system-wide crisis is unlikely given the strong capital positions of large Indonesian banks, weaknesses among smaller institutions could undermine investor confidence, increasing the importance of sound regulatory responses to emerging problems. Net capital flows have decreased markedly since September 2008 as global banks and investors de-leverage and reassess emerging risk. Net portfolio investment in the third quarter of 2008 dropped to \$17 million from \$4.2 billion in the previous quarter. Analysts believe that confidence in the health of Indonesia's banking and corporate sectors has staved off more dramatic capital flight. As a result, any sign of stress in the corporate or banking sectors may strain on investor confidence.

18. (SBU) The regulatory response to the financial crisis to date has been proactive, but pressure on the sector in 2009 will test the regulators' capacity for crisis management. Indonesia's regulators have pumped liquidity into the banking sector and proposed legislation to improve the

JAKARTA 00000227 003 OF 003

financial system safety net. In recent weeks, BI has focused on policies to encourage lending by delaying implementation of (stricter) Basel II capital rules and easing capital requirements for loans to small and medium-sized enterprises. As pressure on the banking sector grows, the regulators will need to intensify monitoring and evaluation of the sector. Slow resolution of problem banks and failure to balance policies that promote loan growth with policies that encourage sound banking practices are also likely to undermine confidence.

HUME